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Supreme Court of the United States

FLAHERTY & CRUMRINE PREFERRED INCOME FUND INCORPORATED, *et al.*,
Petitioners,

v.

TXU CORP., *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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REPLY TO BRIEF IN OPPOSITION

FRANCIS J. BALINT JR.
BONNETT FAIRBOURN
FRIEDMAN & BALINT PC
2901 N. Central Avenue,
Suite 1000
Phoenix, AZ 85012

DAVID W. DODGE
DAVID W. DODGE PC
Regency Plaza
3710 Rawlins, Suite 1600
Dallas, TX 75219

SAMUEL ISSACHAROFF
Counsel of Record
40 Washington Square South
New York, NY 10012
(212) 998-6580

ROSEMARY SHOCKMAN
SHOCKMAN LAW OFFICE PC
3001 E. Camelback,
Suite 120
Phoenix, AZ 85016

Counsel for Petitioners

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20002

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REPLY TO BRIEF IN OPPOSITION

ARGUMENT

I. THE COURT NEEDS TO CLARIFY HOW COURTS ON A MOTION TO DISMISS SHOULD WEIGH THE PLAUSIBILITY OF FACTUAL INFERENCES WITHOUT RESOLVING DISPUTED ISSUES OF FACT.

The Court's recent pleading cases have expanded the boundaries of a district court's inquiry on a motion to dismiss based on the "plausibility" of factual allegations in a complaint. Thus, courts may dismiss a complaint when the facts of record support an inference favoring lawful as opposed to unlawful conduct (*Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 556-57 (2007)), or when it simply tracks the

elements of the underlying cause of action (*Ashcroft v. Iqbal*, 129 S.Ct. 1937, 1951 (2009)), and may additionally dismiss a complaint for securities fraud under the PSLRA[1] if the facts of record do not, of their own, present a plausible inference of scienter (*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322-24 (2007)). However, the Court has not yet established the outer boundaries of the inquiry into "plausibility." No case has yet instructed lower courts how to avoid crossing the line into impermissible fact-finding at the motion to dismiss stage.

As a result of this void, there is a serious risk that in cases like that at bar, a detailed complaint may be dismissed based on a district court's accepting as fact the version of events offered by defense counsel via motion to dismiss. This case offers the Court a clear opportunity to provide guidance to the lower courts on the full import of the refined pleading requirements, signaling not only what may be dismissed as implausible, but what factual allegations must be respected given the early stage of litigation at which a motion to dismiss is made.

The facts in the present case present the critical pleading issues in clear relief. At issue are the public representations made by TXU concerning the likelihood of a dividend payout increase following the close of its tender offer. There is no dispute in this case that the securities at issue were a specialized instrument whose value largely tracked the anticipated dividends from TXU. Both before and during the tender offer period, TXU announced certain financial benchmarks (in turn filed with the SEC)

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[1] Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b) (1), (2)

that conditioned any prospective increase in dividends on the successful completion of the stated financial targets. Those benchmarks in turn projected no increase in dividends until 2006.

Despite the announced benchmark criteria for raising dividends, and despite the fact that the criteria had not been met, TXU increased its dividends by an unprecedented 350% *only eight days after the tender offer expired*. Further, the meeting of the Board of Directors at which the increase was approved had been scheduled well in advance of the tender offer, and all the materials submitted for Board approval were prepared by management *during* the tender offer.

Most critically, during the self-tender period, TXU and its CEO Wilder on September 28, 2004 gave a presentation to analysts in which Wilder reiterated the benchmark criteria applicable to any TXU dividend increase, a reiteration that obscured and misrepresented the preparations that were in fact underway for a massive dividend increase as soon as the tender offer expired.[2]

These facts are all alleged in the Second Amended Complaint ("SAC"), and alleged with great specificity as to when made, why they were so material to the investment decisions of sophisticated investors who

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[2] Inexplicably, Respondents argue that "Petitioners do not allege that TXU took a single action inconsistent with its disclosures." Resp't Br. at 31. The Second Amended Complaint details how the sudden and unprecedented dividend increase was inconsistent with the financial guidelines that TXU had provided to the investing market. *See, e.g.*, Pet. App. 62a-70a (detailing repeated public statements of guidelines for dividend increase, which were disregarded in raising dividends immediately after close of tender offer).

traded in the specialized securities at issue,[3] and why the representations were false when made. Neither the district court nor the Fifth Circuit found that this set of facts as set out in the SAC failed to state a plausible claim of the requisite scienter. Rather, the SAC was dismissed because the district court chose to credit an alternative set of facts advanced by TXU's legal counsel and having no documentary support in any filing before the SEC or other public record. The district court unilaterally concluded that this set of facts was more likely the truth as to scienter, a conclusion that was affirmed by the Fifth Circuit.[4] Such an assessment surely goes far beyond anything envisioned in the Court's recent pleading cases and allows a defendant to move to dismiss on a

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[3] Professor Geoffrey Miller well states the significance of the materiality of the representations to the question of scienter:

> [S]ophisticated businesspeople understand that when information is material—when it is important to market actors in deciding whether to buy, sell, or hold the company's shares—they need to be especially careful to verify the truth of what they are saying . . . . Because people will usually be especially careful when the information is material, as compared to when it is not, the fact that a material statement turns out to be false enhances the suspicion that the person making the statement knew it was false (or was reckless with respect to its truth).

Geoffrey P. Miller, *Pleading After* Tellabs, 2009 Wisc. L. Rev. 507, 517.

[4] Respondent's claim that the scienter issue is not dispositive of the case, Resp't Br. at 29-30, is false. The district court squarely held that "[t]he only real issue in granting the motion to dismiss was whether TXU 'acted with the requisite scienter.'" Pet. App. 39a. In turn, the Fifth Circuit affirmed on the basis that the evidence presented did not establish the intent of TXU and its CEO Wilder to deceive. Pet. App. 21a.

hypothesized set of facts never tested or in any fashion verified.

This case highlights the need to refine the plausibility inquiry because the courts below had to acknowledge not only that Petitioners had set out a plausible claim of liability, but that the facts of record provided specific support to their allegations. Thus, the Fifth Circuit acknowledged that the timing of the dividend increase was "suspect," Pet. App. 15a, that it "provides some support for an inference of scienter," Pet. App. 16a, that the Petitioners' expert report likewise "provides some support for the notion that TXU's management likely made preparations for the dividend increase before the end of the tender offer,"[5] Pet. App. 17a, that the generic disclaimer of "under review" was itself "vague," Pet. App. 18a, and ultimately conceded that the inference of scienter on these facts was "permissible." Pet. App. 20a.

What sets this case apart from *Twombly* and *Iqbal* is that both lower courts here unabashedly substituted their own assessment of the facts for those that had been pleaded. The Fifth Circuit did not—and could not—find that this was a case that could be dismissed at the pleading stage because the allegations were "[t]hreadbare" and "far-fetched." *Limestone Development Corp v. Village of Lemont*, 520 F.3d 797, 804 (7th Cir. 2008) (Posner, J.). Nor did the Fifth Circuit find that the allegations support an

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[5] Petitioners submitted a long analysis of the rating system used by credit agencies to assess utility companies such as TXU. Pet. App. 108a-151a. The author, Dr. Linda Allen, is a Ph.D. economist in finance, specializing in risk management measures. Pet. App. 152a. Respondents erroneously and dismissively refer to her as a law professor. Resp't Br. at 8. Dr. Allen is a professor at one of the nation's leading business schools.

inference contrary to the illegal conduct alleged. *See, e.g., Showalter v. Brubaker*, 283 F. App'x 35 (3d Cir. 2008) (finding "no allegations from which it could reasonably infer" that the defendants acted under color of state law). Nor did the Fifth Circuit find that the allegations were equally consistent with either legal or illegal conduct. *See, e.g., Marrero-Gutierrez v. Molina*, 491 F.3d 1, 9 (1st Cir. 2007) (finding that the facts alleged supported non-actionable motivation for dismissal of state employee). In such cases, the lower courts are operating within the confines of the factual allegations of the complaint to determine whether a presumption of impropriety was created. Such holdings are consistent with the Court's repeated adherence to the "tenet that a court must accept as true all of the allegations in a complaint." *Iqbal*, 129 S.Ct. at 1949.

Here, by contrast, the Fifth Circuit took it upon itself to find that TXU's boilerplate disclaimer that the dividend structure was "under review" had the effect of conveying "that TXU had taken some steps in evaluating a change in the dividend policy," Pet. App. 17a, though that is directly contrary to the allegations in the SAC, to the analysis of market responses by Petitioners' expert, and to the contemporary statements of Flaherty & Crumrine, the lead plaintiff investment firm. Pet. App. 173a. The Fifth Circuit then found that proper disclosure of the imminence of the dividend increase was foreclosed by TXU's fear of liability, Pet. App. 18a, a conclusion tethered to nothing in the record and in fact contradicted by the allegations in the SAC. Most critically, the Fifth Circuit adds that "it can be inferred that Appellees had not made a final decision concerning a change in the dividend policy during the tender offer, and were thus truthfully stating that the policy was

under review." Pet. App. 20a. Again, this runs contrary to the allegations in the SAC and to the evidence in the expert report that describes in great detail the steps that had to be taken prior to a dividend increase of this magnitude.

Outright dismissal of a pleading like the SAC is surely not dictated by *Twombly* and *Iqbal*. The complaint in *Twombly* failed because, despite factual allegations of parallel conduct that were "well-pleaded," the allegations failed to "plausibly suggest an illicit accord" because the underlying parallel economic conduct "was not only compatible with, but indeed was more likely explained by, lawful, unchoreographed free-market behavior." *Iqbal*, 129 S.Ct. at 1950. Similarly, in *Iqbal* itself, the Court refused to allow a broad conspiracy claim to survive against the Attorney General and the Director of the FBI based merely on an allegation that Muslims were being detained after September 11th. The critical question was whether the facts as alleged created a plausible claim under the governing substantive law. Even accepting the facts as pleaded, the Court rejected the claim that "a supervisor's mere knowledge of his subordinate's discriminatory purpose amounts to the supervisor's violating the Constitution." *Id.* at 1949. Instead, liability under the controlling substantive law of *Bivens* must be based on the affirmative conduct of the named defendants, and the complaint did not plead any such conduct.

Ultimately, the issue of the truth or falsehood of the statements made to the investing market is the question for trial. The Court has instructed lower courts to use common sense and inferences to weigh the plausibility of the claims as stated. Because all of

this occurs at the motion to dismiss stage, before defendants have even answered or otherwise committed themselves to affirm or deny the truth of any allegation, and before they are subject to having factual representations tested in an adversarial proceeding, the Court emphasized that the factual universe must be the allegations of the complaint and whatever publicly available material helps make sense of them. Nowhere has the Court invited lower courts to speculate as to the likely correctness of contested facts, much less adopt as dispositive a set of facts outside the pleadings.

While lower courts are struggling to apply the plausibility standard of *Tellabs*, *Twombly*, and *Iqbal*, this case presents a chance to define the boundaries of impermissible fact-finding, as opposed to testing of the plausibility of the claim as asserted. Drawing this line is critical under the recent pleading cases and the Court should grant review to assist lower courts in this process.

II. CONTRARY TO THE OTHER CIRCUITS AND TO THE COURT'S PRECEDENT, THE FIFTH CIRCUIT IS APPLYING A HEIGHTENED PLEADING STANDARD TO COMMON LAW FRAUD CLAIMS AGAINST "CORPORATIONS AND THEIR OFFICERS."

To uphold dismissal of Petitioners' common law claims, the Fifth Circuit squarely held that "certain motives alleged, especially those universal to corporations and their officers, do not suffice to establish an inference of fraud under Rule 9(b)." Pet. App. 22a-23a. Respondents now argue that this application of a higher pleading threshold for motive against corporations and their officers should be disregarded

because the Fifth Circuit actually applies the same pleading standard to all claims, regardless of the nature of the alleged perpetrator of the fraud. Resp't Br. at 15 (Fifth Circuit "has faithfully and consistently applied the same 'inference of fraud' standard in all cases under Rule 9(b) . . ."). But one cannot simply ignore the Fifth Circuit's discussion of the specific claims of misconduct that do not suffice to satisfy the distinct pleading requirement for corporate fraud.

Nor is the application of a special pleading requirement for common law claims consistent with the Fifth Circuit's own pleading rules outside the PSLRA. For example, the Fifth Circuit is clear that under Rule 9(b), a defendant's intent, knowledge, and state of mind for purposes of common law fraud "may be averred generally." *Tuchman v. DSC Commc'ns Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994). Similarly, outside the securities fraud context, the Fifth Circuit has held that pleading fraud under Rule 9 requires particularity only as to the "'time, place and contents of the false representations, as well as the identity of the person making the misrepresentation and what [that person] obtained thereby.'" *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 177 (5th Cir. 1997) (quoting *Tuchman*, 14 F.3d at 1068); *see also Tel-Phonic Servs., Inc. v. TBS Int'l, Inc.*, 975 F.2d 1134, 1138-39 (5th Cir. 1992) (allowing general averment of fraud for RICO predicate acts); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 350 (5th Cir. 2002) (under 9(b), complaint must set forth "the who, what, when, where, and how" of the events at issue) (internal quotations omitted); *Dorsey v. Portfolio Equities, Inc.*, 540 F.3d 333, 341 (5th Cir. 2008) (distinguishing common law fraud pleading require-

ments from PSLRA requirements for pleading scienter).

All of these general pleading requirements were indisputably satisfied here. In order to affirm dismissal of the common law fraud claims, therefore, the Fifth Circuit had to ignore them, as well as underlying Texas law, and instead rely on its own distinct pleading rules for fraud against corporations and officers. This squarely raises the first question presented to the Court: whether there is indeed a heightened pleading standard under the federal rules for fraud allegedly perpetrated by corporations.

There is a related reason for vacating and remanding this case to the Fifth Circuit. The Fifth Circuit did not have the benefit of the Court's opinion in *Iqbal*, in which the Court categorically ruled that the federal rules apply across the board and that federal courts are not free to pick and choose their application to preferred or dispreferred causes of action. 129 S.Ct. at 1953. The creation of a distinct pleading regime depending on the corporate character of the defendant is now squarely foreclosed by *Iqbal*.

Finally, the use of federal procedural law to defeat the Texas pleading standards for common law fraud implicates another issue, currently before the Court in *Shady Grove Orthopedics Assocs., P.A. v. Allstate Ins. Co.*, No. 08-1008.[6] The question presented in *Shady Grove* is whether a state rule prohibiting the use of class actions should be binding when a state law claim is brought in federal court. If the Court were to hold in *Shady Grove* that federal diversity jurisdiction cannot override state law procedures that

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[6] *Shady Grove Orthopedics Assocs., P.A. v. Allstate Ins. Co.*, 549 F.3d 137 (2d Cir. 2008), *cert. granted*, 129 S.Ct. 2160 (2009).

form an integral part of the substantive law governing a particular cause of action, then the Court should vacate the common law fraud portion of the Fifth Circuit's opinion and remand for further proceedings.

CONCLUSION

For the foregoing reasons, the petition for a writ of *certiorari* should be granted.

Respectfully submitted,

FRANCIS J. BALINT JR.
BONNETT FAIRBOURN
FRIEDMAN & BALINT PC
2901 N. Central Avenue,
Suite 1000
Phoenix, AZ 85012

DAVID W. DODGE
DAVID W. DODGE PC
Regency Plaza
3710 Rawlins, Suite 1600
Dallas, TX 75219

SAMUEL ISSACHAROFF
Counsel of Record
40 Washington Square South
New York, NY 10012
(212) 998-6580

ROSEMARY SHOCKMAN
SHOCKMAN LAW OFFICE PC
3001 E. Camelback,
Suite 120
Phoenix, AZ 85016

Counsel for Petitioners